- Similarly, consumer advocates have expressed continuing concern about the misallocation of over investment in the network to local rates and believe that these should be removed.
- Regulation was never intended to countenance inefficiency and the purpose of introducing competition is to eliminate it.
- Regulators never indemnified companies from technological obsolescence and have already compensated them for those risks.

Claims that these are opportunities which would be afforded companies in competitive markets are incorrect. Where decades of monopoly have created artificial scarcity, opportunity costs are meaningless. The difference between the net book historical cost and the so called market value is a function of franchise monopoly status, not economic efficiency. In the transition to competition, we must not overlook the fact that stockholders have been compensated and the fruits of this monopoly belong to ratepayers whose franchise created them and whose rates paid for them.

Moreover, any change in market share will be small and unfold over time. Those investors who are risk averse, will have more than adequate time to dispose of their incumbent LEC holdings at prices far in excess of the book value of the assets that they own. If it becomes necessary to write off investment as so frequently happens in competitive industries, a new set of investors, more tolerant of risk and seeking potentially higher rewards, will enter the industry.

Competitors could be placed at a severe disadvantage as a result of the recovery of "stranded" investment. If the incumbent LECs are allowed to declare investment "stranded" whenever they lose customers and market share, they will be operating with a massive financial cushion. This will lower the risk that they face and continually reinforce their financial position. Competitors, who have no such cushion, will be at a disadvantage.

### 3. Current Law Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

The version of the regulatory compact between stockholders and ratepayers that LECs invoke to make their claims for stranded cost recovery never existed.[33] The guarantee of recovery that LECs claim is an ex post effort to recover assets and recoup actions for which management bears responsibility and stockholders have already been handsomely compensated.

To compensate companies for uneconomic investments, when they have already been compensated for the risk of those investments, constitutes a double recovery of costs which violates the fundamental principles of just and reasonable rates. Far from guaranteeing this complete recovery of all costs rendered uneconomic by competition, current law places the burden of the risk of competition squarely on the shoulders of utilities and shields them, at best, only from the most dire financial outcome -- bankruptcy. The extremely strong financial performance of local exchange companies undermines any claims that failure to recover obsolete and uneconomic investment will threaten the financial soundness of these companies.

### 4. Exposure to Risk is Not a Taking

Another problem with the LEC taking claims, as described in federal proceedings, is that they readily admit that there is not a taking at all in any direct sense, only a reallocation of risk. The assertion that the pricing scheme contemplated by the FCC would take their property rests on the claim that they would not be able to alter their prices for non-core services in the

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[33]GTE, Oklahoma, "Universal Service...," p. 24, SWBT, Oklahoma, p. 24.

marketplace to recover those costs.[34] This is absolutely not certain. To the extent that they are more efficient or more effective competitors, they will retain customers and there cannot possibly be a taking.

> With ILEC rates set at incremental cost, to the extent that market conditions preclude raising other prices, ILEC revenues and earnings will decline.[35]

The argument being made by the LECs about the marketplace assumes that the entrants do not have joint and common costs of their own. If the entrants do have joint and common costs, which they most certainly would, then the LECs will be able to recover their common costs. To the extent entrants have lower joint and common costs, the LEC should not recover its excess costs.[36]

**5. New Opportunities Offset New Risks**

As noted above, in the context of the federal legislation, it should also be recognized that there are important up-side opportunities for the LECs to enter new markets. Many of these markets can be served with the facilities that have been deployed to serve the local exchange market. For regulators to recognize only the down-side potential but not the up-side would bestow all the benefits on the companies while imposing all the costs on ratepayers. The exposure to risk in their current businesses is more than offset by the opportunity of revenue in the businesses which will be opened to them. The LECs repeatedly state that entry into long

[34]We maintain that there is no economic need for rate rebalancing for universal services. In fact, permitting rate rebalancing would be extremely anti-competitive and anti-consumer.

[35]SBC, p. 91. (emphasis added)

[36]Ameritech clearly recognizes that its competitive entrants will have common costs. Ameritech p.67.

distance is a strong incentive to negotiate in good faith.[37] This strong incentive is a profit and revenue opportunity. Even if they were to lose some revenue in their current lines of business, above and beyond the billions of excess built-in, they could more than make up those revenues in the businesses opened up to them. No statement better summarizes the vast opportunities opened to the LECs than the following from its trade association

> The passage of the Act offers additional opportunities for many new market entrants. Specifically, it breaks down regulatory barriers and opens up local telephone, long-distance service and cable television to competition, thereby eliminating many of the restrictions that have prevented telephone companies, long-distance carriers and cable and utility companies from competing with each other. IXCs, cable television companies, RBOCs, and new entrants in the telecommunications marketplace all stand to gain a great deal from the provisions in the new Act. Specifically, the Act removes the ban that prohibited the RBOCs from entering the interstate market that was essentially dominated by AT&T, MCI and Sprint.[38]

### 6. Takings Claims under Regulation Involves Outcomes, Affecting the Overall Rate of Return, not Cost Categories or Even Specific Assets

The case law that the LECs frequently cite to attempt to dissuade the Commission from adopting a pro-competitive pricing approach to network elements makes it clear that takings involve only the most dire of outcomes.[39] The Supreme Court held that the overall result of the regulatory process had to be a rate of return that in the aggregate was confiscatory. The specific treatment of even specific assets, not to mention amorphous categories of cost, is not the basis for a takings claim. There is no constitutional guarantee of recovery of all costs, even when

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[37]USTA, p. 6; SBC, p. 11.

[38]USTA, P. 89.

[39]USTA, Local Competition.

they are prudently incurred, there is only a guarantee of the opportunity to earn a rate of return that is not so low as to be confiscatory.

The constitutionality of a takings argument that rests on an entirely uncertain argument about the relative efficiencies of competitors in the market, how competitors will allocate and recover their joint and common costs, and where every new risk is offset by a profit opportunity is dubious at best. It is certainly not a basis for failing to implement the pro-competitive policy that Congress clearly had in mind when it passed the 1996 Act.

## C. CONCLUSION

After the Commission has purged the revenue requirement of the companies of these illegitimate costs and allocated joint and common costs reasonably between services, it will find that redesign of rates is not necessary. The universal service fund mechanism at the federal level, combined with a state level universal service fund should be more than adequate to handle any targeted subsidies for high cost areas, low income households, and consumers with disabilities.

## VI. RATE REBALANCING AS UNIVERSAL SERVICE POLICY

### 1. THE MAGNITUDE OF COST SHIFTING

With the exception of one major local exchange company (NYNEX)[40] and one major long distance carrier (MCI),[41] at the Federal level, the industry proposes to raise rates for core telephone service by at least $2.50 and by as much as $10.50 per month. Some companies pick a target price in dollar terms.[42] Others pick a target price in terms of a percent of median

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[40]"Comments of NYNEX," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter NYNEX).

[41]The MCI proposal ("MCI Comments," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter MCI), pp. 13-14) proposal would reduce the payment of long distance companies for the use of the telecommunications network by $13 billion, but argues local rate increases should not be allowed to offset these reductions. MCI believes that the difference is made up of inefficiencies which would not need to be recovered in a competitive market. We suspect that such a large reduction in revenues would hardly go unnoticed by state regulators. The local companies have certainly argued that any reduction in their revenues from long distance companies must be made up.

[42]MCI (p. 4), "Comments of AT&T Corporation," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter AT&T) advocates an increase of $3.50 per month in the EUCL (p. 16). It also advocates a reduction in access charges equal to approximately $11 per month, arguing that the difference will not be reflected in residential ratepayer bills, although it would not preclude rate rebalancing (pp. 6-7). AT&T's affordability standard is determined only by penetration rates (p. 16), as long a penetration does not decline, core service rates can rise, and therefore ultimately would allow much larger rate increases. AT&T (Appendix B); "Comments of the Florida Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Florida), p. 5, use $20. Sprint refers to national urban average price "Comments of Sprint Corporation," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Sprint, p. i.). Sprint also advocates requiring states to rebalance rates up to a federal benchmark (p. 5). Sprint extends rate rebalancing well beyond access and toll, however, arguing that states must rebalance business and intrastate access charges and adopt state subscriber line charges (pp. 19-20). For rural areas, the rate increase would include at least a $3 increase up to the national urban average, plus at least a $2.50 increase in subscriber line charges.

income, either statewide[43] or nationwide.[44] Others simply argue for rate rebalancing.[45] Implicitly and explicitly they argue that rates should be set at this level.[46] The long distance companies serving the vast majority of customers in the state -- AT&T, Sprint, and LDDs[47] -- appear to endorse this proposal.

Southwestern Bell has been particularly prominent in arguing for an affordability benchmark of 1 percent of statewide median income. Its initial comments in the Federal

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[43]"Comments of Southwestern Bell Telephone Company," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter, SWB), Attachment 4, proposes a one percent of income limit.

[44]"Comments of the United States Telephone Association," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter USTA), pp. 16-17 .

[45]"GTE's Comments," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter GTE), does not state any specific estimates of the resulting increases in basic rates, but it presents one of the most aggressive proposals to raise and rebalance rates which inevitably would lead to large increase in basic rates. The proposal includes dollar-for-dollar revenue replacement (p. 9), immediate and total rate rebalancing for access, toll, business and enhanced services (p. 14), an increase in the EUCL (p. 15), deaveraging of the EUCL (p. 15), complete recovery of all embedded costs including depreciation reserves (p. 16), and a surcharge placed on ratepayers bills to recover universal service fund costs (pp. 16-17).

[46]Once a benchmark price is established, the company providing the service cannot make claims on the universal service fund for any revenues lost because rates are below the benchmark. This creates pressures to raise rates to that level. All of the local companies have requested either rate rebalancing or pricing flexibility (NYNEX) to accomplish the increase in rates. Thus, it seems clear that the benchmarks will be the target prices that local companies will seek to impose.

[47]"Comments of LDDS Worldcom," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter LDDS), argues for an increase in the subscriber line charge and the removal of all "non-cost-based" expenses from access charges, which the companies would "be free to either "absorb internally" or "pass them along to consumers in their retail rates (p. 5).

Universal Service proceeding clearly advocated adopting a benchmark which would have raised basic monthly service rates dramatically.[48] Its reply comments leave no doubt about the fact that it would like to set rates at that level.

> While the parties disagree on where this benchmark should be positioned and how it should work, the parties do recognize that such a definitive benchmark is essential to meeting the Act's mandate. AT&T argues that an affordability benchmark should be established based on current local exchange prices levels plus an increased SLC. This level is too low because this approach incorrectly assumes that basic local telephone service is currently appropriately priced. Before any consumer can expect others to help pay for universal service, that consumer should be required to first pay a reasonable and affordable price. An affordable price should be determined by comparison to the average consumer's spending on other goods and services as detailed in SWBT's Comments in this proceeding. An overall affordability benchmark set at 1% of the State's median income represents a proper balance among the needs for more appropriate cost recovery, appropriately sizing support funds and supporting high cost markets.[49]

This recommendation makes it clear that Southwestern Bell is proposing that consumers "should be required to first pay a reasonable and affordable price," which SWBT puts at the benchmark rate which is equal to 1 percent of statewide median income. For year end 1994, which is comparable to the rates analyzed above, the benchmark rate in Texas under this approach would be about $25 per month. SWBT includes a federal subscriber line charge increase to $6 under this benchmark cap. Compared to rates in Texas, this represents an increase of about $10 per month.

GTE advocates similar benchmark pricing, with less precision than SWBT. GTE's Reply comments endorse a percentage of median income as the benchmark.[50] In its comments in

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[48]Southwestern Bell, Initial Comments, p. 11.

[49]"Southwestern Bell, Reply Comments, p. 19.

[50]GTE, Reply comments, p. 10.

Oklahoma, GTE suggested that overall average rates could be raised in that state by raising all rates to the highest current rate in the state.[51] This essentially raises rural rates to urban levels. The hypothetical example set the highest rate at $17.50. As table III-3 above showed, this is almost exactly the highest monthly charge in Texas. The GTE example does not take into account any increase in the federal subscriber line charge.

### 2. REVENUE NEUTRALITY IN THEORY AND PRACTICE

The first line of defense that the LECs offer for the increases in monthly rates for core services is revenue neutrality. They claim that long distance companies (IXCs) would pass through the lower costs they experience in the form of lower long distance bills. They claim that the long distance reduction would offset any increases in the monthly bill for core services paid by consumers. The local companies make similar claims with respect to their intrastate rate rebalancing.

In our view, the "revenue neutral" outcome is highly unlikely to occur even in the aggregate. Moreover, to the extent that some rates are lowered to offset rate increases, the majority of individual residential ratepayers are not likely to see a neutral outcome in their bills. To the contrary, they are likely to experience net increases in their bills.

On the long distance side, competition is not strong enough to force a pass-through quickly. IXCs will try to hold onto as much of the reduction in their costs as they can for as long as they can. Price leadership by AT&T and "umbrella pricing" by its much smaller competitors are more likely to characterize how the market functions.

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[51]GTE, Oklahoma, Attachment A.

To the extent that competition does force the pass-through of cost reductions, it is likely to benefit the more or most competitive market segments first. High volume and business users will benefit the most.[52] Residential ratepayers will see price reductions last and least.

On the local side, the extreme pricing flexibility most LECs now enjoy and seek to have expanded would mean that revenue neutrality would not endure. Profits have been deregulated for many companies. The companies have an incentive to shift costs onto the most regulated prices of customers who have the fewest choices. These would be offset by cost reductions for the least regulated services. The companies will rapidly increase their profits by raising prices as quickly as possible wherever possible, while targeting price reductions to their most competitive lines of business. The average residential ratepayer will benefit least.

The likelihood that competition in local markets will prevent this outcome in the short term is small. First, local companies do not face effective competition for core telephone service in the residential market. Indeed, competition in this market is virtually non-existent. The vast majority of the LEC revenue stream remains essentially a monopoly service and therefore cost shifting will ultimately result in a net increase in residential bills. The conditions necessary to promote competition are complex. Although the new state and federal laws have the purpose of stimulating competition, it remains to be seen how quickly new entrants can actually enter local markets. Until they do, rate rebalancing will result in a net increase for residential ratepayers.

[52]At least one of the large business groups filing comments to the FCC supports rate rebalancing (see Ad Hoc Telecommunications Users Committee).

## 2. The Distributive Impact of Rate Rebalancing

Even if rates for non-core services are lowered in an amount equal to the aggregate increase in core services, the distribution of the rate increases and decreases will be not be even. The explicit purpose of rate rebalancing is to shift costs away from intensive users of the network. It is not surprising to find that lower income groups will receive a disproportionately smaller share of the benefits and pay a disproportionately large share of the costs of rate rebalancing, since they are much less intensive users of the network. Similarly, large business users will receive more benefits than residential ratepayers.

Table VI-1 shows national average consumption pattern across income groups. On average, all income groups paid an average of approximately $18.80 for telephone service in 1993 (the most recent year for which data is available). The national average expenditure for non-core services was $39.40, but averages can be misleading.

The bottom fifth of the population spent $28 for non-core services. The next poorest one-fifth spent about $29.20 for non-core services. For the income groups above this level, the spending on non-core services increases rapidly. For those among the top one-fifth of households, over $57 is spent on non-core services, twice as much as lower income households.

Section B of Table VI-1 assumes revenue neutral, across-the-board rebalancing. This results in net increases in bills for the poorest households and net decreases in bills for the richest. A $10 increase in the basic service bill requires a 25 percent decrease in non-core revenues ($10/$39.4 = .25) in the aggregate to achieve revenue neutrality.

TABLE VI-1:
WEALTH TRANSFER FROM RATE REBALANCING

A: 1993 AVERAGE BILLS

| | NAT. AVG. | QUINTILES Poorest | 2ND | 3RD | 4TH | RICHEST |
|---|---|---|---|---|---|---|
| TOTAL BILL | 58.20 | 46.80 | 48.00 | 55.80 | 61.50 | 76.30 |
| NON-CORE | 39.40 | 28.00 | 29.20 | 37.00 | 42.70 | 57.50 |
| CORE | 18.80 | 18.80 | 18.80 | 18.80 | 18.80 | 18.80 |

RATE REBALANCING OF $10

B: REVENUE NEUTRAL REDUCTION SPREAD ACROSS RESIDENTIAL RATEPAYERS

| | NAT. AVG. | QUINTILES Poorest | 2ND | 3RD | 4TH | RICHEST |
|---|---|---|---|---|---|---|
| TOTAL BILL | 58.20 | 48.89 | 50.58 | 56.40 | 60.65 | 71.70 |
| NON-CORE | 29.40 | 20.89 | 21.78 | 27.60 | 31.85 | 42.90 |
| CORE | 28.80 | 28.80 | 28.80 | 28.80 | 28.80 | 28.80 |

C: REVENUE NEUTRAL REDUCTION SPREAD ACROSS ALL RATEPAYERS
(50% NON-CORE ASSUMED TO BE BUSINESS)

| | NAT. AVG. | QUINTILES Poorest | 2ND | 3RD | 4TH | RICHEST |
|---|---|---|---|---|---|---|
| TOTAL BILL | 63.20 | 53.25 | 54.29 | 61.10 | 66.08 | 79.00 |
| NON-CORE | 34.40 | 24.45 | 25.49 | 32.30 | 37.28 | 50.20 |
| CORE | 28.80 | 28.80 | 28.80 | 28.80 | 28.80 | 28.80 |

SOURCE: McMaster, Susan E. and James Lande, Reference Book: Rates, Price Indexes, and Household Expenditures for Telephone Service (Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, November 1995), Table 4.

The above analysis assumes that reductions for non-core services are spread uniformly across the services that residential ratepayers use. In fact, non-residential ratepayers would also receive a large share of the benefits, since they consume much larger quantities of the non-core services. Local companies frequently point out that their revenues are highly concentrated among specific segments of business customers. Few if any of the increases in charges for core services are targeted for these customers. Even if an across the board reduction in service prices were made, few, if any, the benefits would flow to residential customers.

Section C of Table III-3 presents another analysis of the distributive impact of rate rebalancing assuming that half of the rate reductions for non-core services are enjoyed by non-residential customers. This results in much larger net increases in bills for the poorest households and a smaller net decreases in bills for the richest. A $10 increase in the basic service bill requires a 12.7 percent decrease in non-core revenues ($5/$39.4 = .127) in the aggregate to achieve revenue neutrality. In sum, for the poorest 40 percent of the population, a $10 increase in monthly rates for core services translates into a $6.50 increase in its telecommunications bill; while the richest 20 percent suffers a net increase in their bill of $2.70.

**3. Expanding Lifeline Programs**

The LECs recognize that even if revenue neutrality could be achieved, it would not allay all concerns about rate impacts. Increases in monthly charges for core services to fund reductions in charges for other services will fall most heavily on those who buy less of the other services. Core services are a necessity and rate increases in this area are not bypassable. The LECs generally support expanding Lifeline programs to include more people and to cover at least part of the rate increase. Under the current structure of Lifeline programs, the FCC reduces federal SLC in an amount equal to the discount a state offers to low income households on basic monthly services. For a state fully participating in the Lifeline program, the total discount would be $7.00 (a complete waiver of the current $3.50 SLC matched by a $3.50 reduction in basic rates).

The Lifeline program does not provide relief for the working poor and lower middle class. There are another two million households who would be paying substantially more than one percent of income who would not be eligible for the program.

Even for those households that are eligible, the relief is less than appears at first glance.

- These households would receive a waiver only for the federal subscriber line charge. No relief is offered for state rate rebalancing.
- Participation in Lifeline programs is quite low, so that many of the households who are eligible are unlikely to receive the benefits.

If the SLC were increased by $2.50 (roughly the amount needed to eliminate the Carrier CCL) and the FCC simply added this to the current policy, Lifeline rates would be discounted by an additional $5, if the states decided to match this amount. Thus, only if rate rebalancing were held to an amount equal to the increase in the federal SLC and the state decided to match that increase, would Lifeline subscribers be held harmless.

## A. PUBLIC POLICY RECOMMENDATIONS

We believe that the proposals to increase basic rates fail a wide range of legal and economic tests as outlined in the previous sections. LEC proposals violate the explicit provision of the federal law which require core services to bear only a reasonable share of joint and common costs and that competitive services not be cross-subsidized. They lack an evidentiary basis establishing that their local rates do not cover their costs. They are based, at least in part, on regulatory theories of guaranteed recovery of costs that violate fundamental principles governing just and reasonable rates and have been consistently rejected by the courts.

The proposals to raise monthly rates for core services are not only contrary to the law, they are also bad public policy and especially bad universal service policy (which is, after all, intended to be the purpose of this proceeding). An increase in basic rates would ultimately result in a net increase in the telephone bills of residential ratepayers, and would fall most heavily on the very groups who are least able to afford telephone service.

## VII. TARGETED PROGRAMS TO PROMOTE UNIVERSAL SERVICE

The previous three sections have dealt with the fundamental rate structure for the vast majority of consumers. It has been demonstrated that current rates cover costs and that rate rebalancing which would dramatically increase basic monthly rates is not necessary or proper. This does not mean that no targeted programs are necessary. In fact, as the concept of basic service expands and competition enters the marketplace, targeted programs do become more important. Access to telecommunications becomes more important and specific market segments may not be attractive to companies motivated only by profits.

Given the major changes in industry structure, this would be an appropriate moment to ensure full participation in the Lifeline program, expand programs for consumers with disabilities, and to set programs to support service in high cost areas on a sound footing.

Thus, we believe that the Commission's sixth question should be addressed first from the point of view of how to expand programs to better achieve the goal of universal service.

6. WILL THE UNIVERSAL SERVICE FUND, AS MODIFIED BY PURA95, BE ADEQUATE TO MEET TEXAS' NEEDS FOR UNIVERSAL SERVICE? IF NOT, WHAT ADDITIONAL CHANGES WOULD YOU SUGGEST?

This section looks at the benefits side of these programs and how funds should be generated.

## A. JUSTIFICATION FOR EXPANDING PARTICIPATION IN TARGETED PROGRAMS TO ENHANCE UNIVERSAL SERVICE

In the past decade telephone companies have begun to shift their focus from the provision of basic telecommunications services -- the ability to place and receive voice grade calls -- to providing enhanced services. Their emphasis has shifted to capital deepening, which is not necessary to meet the demand for basic voice grade communications. In the decade ahead, this process will certainly accelerate, as companies move into many new lines of business. Modernization of the network and provision of enhanced services is a laudable goal, but it is not the only goal of the system. The costs of modernization must not be borne by those who seek only to meet their basic needs for daily telecommunications through the network.

This would be of no concern to users of basic residential services if the costs were being fully borne by the users who are causing it to be installed. The allocation of the costs and benefits of each piece of equipment deserves close scrutiny because the network is now pursuing multiple goals. Rigorous cost accounting would shift costs from the residential sector, in general, and the low income segments of the residential sector in particular, to other sectors. In the new period of capital deepening an effort must be made to identify the costs imposed on the network more carefully for precisely defined classes of consumers. The Lifeline program should be designed to ensure that the goal of universal service is not compromised by the LECs' subsidiary goal of providing enhanced services and moving into the information age.

Rigorous cost-causative analysis will show that low income consumers impose fewer costs on the network. They have less of the more exotic or specialized demands that have been imposing costs on the system. The extremely expensive design and engineering criteria of the network have been imposed on the system to meet the needs of services other than basic local exchange.

This argument applies to all residential subscribers. However, it should apply even more forcefully to lower income households since they are disproportionately not users of the more exotic services. In light of the fact that universal service has not been achieved, it is especially important that modernization expenditures and costs not be allowed to further delay accomplishment of the primary goal of the network. A Lifeline program is one way to ensure that this does not happen.

Much of the recent thrust for price changes in the telephone industry stems from an assertion that companies must price their toll and enhanced services to avoid revenue erosion from competition -- bypass of the network.

These arguments seem to have lost sight of the simple fact that lower income households can be driven off the network too. Judging by penetration rates, the greatest current bypass of the network occurs among low income households. The arguments used to justify differential pricing for price sensitive business customers apply equally, if not with more force, to low income households. Insofar as lines are in place, a good case could be made that service to low income households should be incrementally priced. If low income households are properly priced, they can be induced to stay on the network and make a contribution to fixed costs.

There are two economic externalities that indicate that ratepayers would be better off with Lifeline programs in general. An externality arises when the action of one person affects the welfare of another person in a way that is not reflected in the market prices.

First, ratepayers derive a benefit from having a larger network. The more people one can reach, or be reached by, the more value the network has. Businesses in particular benefit from a denser network.

Second, society in general benefits from the expansion of the network. As members of society are able to contact each other more efficiently, the overall welfare of society increases. Individuals are more productive. In some cases, public health is improved. For example, prenatal care is frequently dispensed by telephone. Better prenatal care can avoid many health problems -- increasing the health of individual members of society.

Some of these benefits may result in a lowering of costs to members of society. Increasing productivity and improving health may lower health care costs or the costs of other social program that are paid by taxpayers. Thus, although ratepayers are charged a little more as a result of the Lifeline program, they get significant benefits as ratepayers and taxpayers.

Given the Federal decision to match local Lifeline discounts up to the amount of the federal subscriber line charge, this indirect externality has been increased. Because of the manner in which the federal matching funds are raised, there is a net transfer of funds into the state. For every dollar shifted in revenue requirement, there is a two dollar increase in the resources available to households enrolled in the program, but transfers within the state are less than two dollars. Thus, the impact of the program on their productivity, health, etc. is multiplied to the good, from the ratepayer and taxpayer point of view.

In light of the above discussion we must be concerned about how to ensure that the externalities are captured and what impact they have on the analysis of economic efficiency and social equity.

Economic theory generally suggests that lump sum taxes are the way to raise funds for a Lifeline program and monetary transfer payments dispersed through public assistance programs are the way to distribute the resources. However, the unique nature of the phone system dictates otherwise.

Direct payments to eligible recipients, if that were a possibility, would not necessarily capture the full benefits of the Lifeline program. The direct external benefit of the telephone is a true externality. That is, network value is not necessarily optimized when individuals optimize their personal welfare. Some people would take the increase in their income but not join the network. They would allocate their resources according to their personal needs, such as for food and shelter. The ratepayers who could benefit from a denser network would not derive the full benefit of the program because the penetration rate would not be raised to the optimum.

Funding a program to increase penetration rates through the tax structure constitutes a transfer of welfare from some taxpayers who derive no such benefits to ratepayers who do derive this benefit. Their loss of welfare may not be offset -- in an efficiency sense -- by the gains in welfare of ratepayers. Because of the network externality, aggregate efficiency and equity are served best by a transfer from ratepayers delivered to eligible households through the rate structure. In this way, subscribers to the network are assured that they get the benefit of having a more ubiquitous network (e.g. businesses have more people they can reach, public health agencies can be more easily reached by households in need of assistance, etc.).

## B. APPROACHES TO EXPANDING PARTICIPATION

Since the goal of these programs is to maximize the size of the network and relieve the burden that having a phone places on household budgets, eligibility criteria should be inclusive, rather than exclusive.

In the Lifeline program for example, the program should not be targeted just to households who are currently enrolled in or eligible for any of the four major public assistance programs -- Aid to Families with Dependent Children, Supplemental Social Insurance, Medicaid and Food Stamps -- but also to households with incomes below 125 percent of poverty.

Because so many low income people are not enrolled in any public assistance program, we believe Lifeline programs will fall far short of Congress's goal of promoting universal service at just, reasonable and affordable rates for these populations, if the policy relies only on enrollment in specific programs to establish eligibility for universal service support. Therefore, it should also establish a self-certified income limit of 125 percent of poverty as an enrolment criteria.

Setting the cut-off at 125 percent of poverty accomplishes a number of purposes. Households eligible for these programs are obviously low income households. The empirical evidence indicates that low income households are the households who are most likely to drop off the network as a result of rising prices. At 125 percent of poverty, income is roughly

$15,000 as an upper limit. In Table III-5 we showed that approximately 80 percent of the households in Texas that lack telephone service have incomes below this level. This effectively targets the population at risk for losing telephone service. It also targets the population for which service at current rates imposes a serious burden on household resources.

Self certification of eligibility, with periodic auditing of recipients, is cost-effective for administering the program. Self-certification coupled with partial auditing would be the most cost effective mechanism.

A similarly inclusive approach should be taken for consumers with disabilities. For example, Wisconsin allows self-certification for support. It allows the subscriber to identify those services -- CPE or network services -- which best suit the needs of the consumer.

Here we can directly respond to another of the Commission's questions.

8. RECOGNIZING THAT UNIVERSAL SERVICE SUPPORT MECHANISMS WERE CREATED TO IMPROVE ACCESS TO TELECOMMUNICATIONS SERVICE FOR ALL TEXAS CONSUMERS, ARE THERE OTHER NON-FINANCIAL, NON-RATE MEASURES THAT CAN BE TAKEN TO IMPROVE TELEPHONE SUBSCRIBERSHIP IN TEXAS?

In order to promote universal service among low income households, the following services should be included in universal service and supported by federal programs:

- The basic service package as identified earlier in Table III-3. As noted earlier the set of services makes subscribership attractive to consumers by tailoring the set of core services to their needs. For example, long distance blocking enables low income households to control their toll bills.
- Installation charges should be reduced (the Link Up Program) and deposits lowered or eliminated to lower the cost hurdle for low income households.

- The Commission should also require policies that do not impose additional barriers for low income households to obtain telephone service. Therefore, the discount should be available on the primary line into the home, but recipients should be allowed to buy optional services at regular rates. Allowing customers to purchase these options at regular rates enables them to be full participants in the purchase of telecommunications services.
- Finally, the Commission should not allow service to be disconnected for non-payment of long distance bills. Long distance is a separate service that will be sold by competing companies. Bill collection for long distance should not be leveraged by the provision of local service.

## C. HIGH COST AREAS

There must be a carrier of last resort designated for each area of the state. Public policy will simply not allow basic telephone service to be unavailable in an area.

The provider of last resort will be responsible for the maintenance of the facilities necessary to provide basic telephone service. The availability of facilities is the key to the availability of service. Responsibility for facilities is the key distinction between carrier of last resort obligations and other obligations. A new entrant might be making service available to all customers within a given area through resale and therefore could not serve as the carrier of last resort.

The carrier of last resort can only draw from the fund to support its obligation to maintain facilities in high cost areas. For the vast majority of lines in the state, being the carrier of last resort creates no unique economic burden because rates cover costs. Only in areas designated by the Commission as high cost will the carrier of last resort be allowed to receive support to cover the difference between the cost of service and the rates charged.

To the extent that an area is a "high cost" area, there should be only one service provider allowed to draw funds from a subsidy pool to support service. Providers could split the subsidy in proportion to their responsibility for maintaining facilities in an area. New entrants drawing from the fund must be facilities-based for the customer for which they seek certification as the carrier of last resort, and must also be willing to shoulder the obligation to maintain those facilities, i.e. it should seek designation as a carrier of last resort where it has facilities.

It makes no sense from a public policy or efficiency point of view to subsidize the existence of more than one supplier in a high cost area.

In order to estimate the amount that can be drawn from the fund the Commission should require the carrier of last resort to make additional showings. The amount to be recovered from the universal service fund to meet carrier of last resort obligations should be no larger than the lesser of 1) the difference between a properly estimated benchmark of cost and rates in effect in the area, or 2) any documented revenue shortfall in the aggregate. If the company is earning its authorized rate of return in the aggregate, it is not suffering any loss due to the obligation to serve that it bears. If the company is earning its allowed rate of return through the rates it charges the public and the Commission allows it to draw additional funds from the universal service fund for its carrier of last resort obligations the company will immediately be in a situation of excess earnings.

The carrier of last resort must demonstrate the prudence of investments which it claims have been made to meet its carrier of last resort obligations. The costs it claims to need subsidized must be prudently incurred and used and useful.

The carrier of last resort should not be allowed to earn a return on capital that is no longer used and useful.

All revenues associated with investments must be included in any calculation of any loop specific shortfall. That is, revenues associated with vertical services as well as toll services should be included in any estimation of the underperformance of assets.

The company should not be allowed to claim a loss on a subscriber line, when it is making very high profits on monopoly vertical services, such as call waiting, which use that line. Nor should the loop which is used for a variety of services -- local, enhanced and long distance -- be attributed solely to local services. All services which use the loop should pay for their use. The shared nature of the loop can be taken into account either through cost allocation or through revenue attribution, or both. The line between what is a "reasonable contribution to shared costs" and what is a "subsidy" is difficult to draw. The most effective approach is to include all revenues in estimating the viability of high cost exchanges.

The area for which the company claims high cost to be covered from the universal service fund must be defined to include reasonably contiguous or immediately adjacent areas with lower cost or higher revenues. Just as new entrants must not be allowed to engage in cherry-picking, therefore the incumbent should not be allowed to cherry pick its own tree by segmenting small highly profitable areas from nearby high cost areas.

On a going forward basis, the Commission must not allow incumbents to enjoy a risk free investment that earns a risk premium. Being paid for costs from a "social obligation pool" removes those revenue streams from market risk. Rates of return earned on USF investment should be lower than company wide rate of return.

The Commission has set rates for decades to recover an overall revenue requirement based on the total investment of the company. A social obligation pool pulls certain assets out of that overall rate base and treats them differently on a going forward basis. The company is given protection against risk of above reference price costs by recovering these revenues from a social fund, not the marketplace. This arrangement clearly eliminates major components of risk associated with the assets. Therefore, in calculating the potential draw from any carrier of last resort pool the lowered risk of the assets must be taken into account.

21. REFERENCING SECTION 3.608(d)(1) AND THE FEDERAL TELECOMMUNICATIONS ACT, WHAT ELIGIBILITY CRITERIA SHOULD BE ESTABLISHED FOR TELECOMMUNICATIONS PROVIDERS AND LECS TO RECEIVED INTRASTATE USF FUNDS? SHOULD THE SAME CRITERIA BE USED TO DETERMINE ELIGIBILITY FOR INTERSTATE USF FUNDS?

With respect to end-user programs, companies serving targeted individuals should have to document that they are serving such an individual or entity and that the individual or entity actually received the discount. The amount of the discount will be set at a state-wide level.

For companies claiming support as high cost, carrier-of-last resort companies, there should be a more detailed process as described above.